Insurance-linked securities:

A VALUABLE DIVISIFIER

Investing in Insurance

Sidney Rostan sheds some light on the Insurance-linked securities (ILS) market

PAGE 40

An attractive niche

Sandra Haurant examines the case for pension funds looking to invest in ILS

PAGE 42

In association with:

SCOR Investment Partners

INVESTMENT

Investing in insurance

***European Pensions* speaks to Sidney Rostan, senior ILS portfolio manager, SCOR Investment Partners about the insurance-linked securities (ILS) market**

So what exactly are ILS and how popular are they with pension funds?

As financial instruments allowing insurers and reinsurers to transfer risk into the capital market ecosystem, insurance-linked securities (ILS) have become more and more familiar and popular with both insurers and institutional investors over the past decade. For insurers, they offer the capacity to de-risk and to diversify their sources of protection. For institutional investors, they offer diversifying yields, as the value of the asset is largely driven by the occurrence of natural catastrophe events that are not correlated to the financial markets.

How have ILS emerged?

Further to Hurricane Andrew, which made landfall in Florida in 1992 causing $15.5 billion in insured losses, the resulting shortage of reinsurance capacity prompted reinsurers, banks, and academics to investigate new ways of transferring catastrophe risks outside the traditional reinsurance capital pool. In 1997, USAA issued Residential Re, the first catastrophe bond to capital markets investors, protecting the insurance company against the risk of a major hurricane. Since then, approximately $91 billion of catastrophe bonds (cat bonds) have been issued, providing protection to insurers, reinsurers, governments, and corporations for a multitude of risks.

How is the ILS market growing?

Due to its undeniable diversification benefits and historically attractive risk-adjusted yields, the ILS asset class has expanded strongly during recent years. In terms of issuance volume, the market broke records in 2017 with $10 billion of cat bonds issued in the first semester (versus $7 billion for the full 2016 year). On the asset management side, the growth of assets under management benefitted an increasing number of investment managers.

However, this large inflow of liquidity is taking place in the context of a softening market in the reinsurance industry. Indeed, due to the lack of important disaster and losses over the past decade, the returns offered have continuously fallen year after year since 2012.

Would the recent events, such as hurricanes Harvey or Irma change the paradigm of ILS market?

The succession of two major hurricanes land-fall in the US in less than a two-weeks period time is a premier at least in the last 150 years. However, it is still too soon to determine if Hurricane Irma would be the test for the ILS market. Irma is a major hurricane that is going to be ranked among the costliest in the insurance, reinsurance industry and ILS industry. Investors in the ILS market may experience their largest loss in years. Volatility will also run high during the weeks following these events.

Eventually, the current period does remind investors that the asset class involves significant insurance risks in case of the occurrence of one or a succession of severe natural disasters.

Is there anything else investors should consider when looking at ILS?

Beyond the headlines, the two points investors should pay attention to are selectivity and consistency. In all markets benefiting from large new sources of capital, the temptation for issuers to propose more aggressive structures is high. ILS does not derogate to the rule. Over the past few months, the market has proposed top and drop or cascade structures, while some deal with no franchise, for example. Such structures imply more risk for investors, therefore in the current market conditions selectivity is key in order to limit bad surprises in the future.

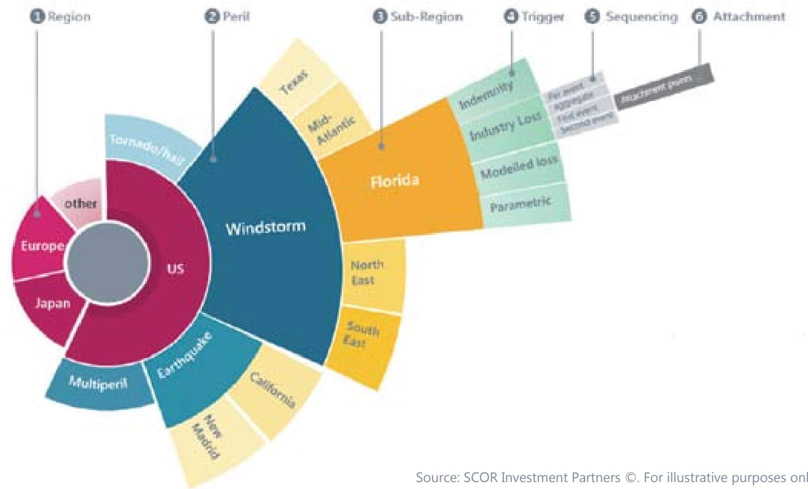
Consistency is the other side of the mirror. One may be tempted to deploy the new cash by diverging somehow from its initial investment strategy. This could be by either increasing the portfolio risk to maintain a high level of remuneration or by investing in new lines of business that support more model risk. And in the ILS market like any other, the voice of wisdom is often common sense.

For instance, take only the risks that one understands. In the ILS world the rule applies and the diversification of the portfolio must not be at the expense of risk control.

As a result, one may favour portfolios that are exposed only to natural catastrophes on which the market benefit from robust models based on long-term data.

But actually, it is interesting to note that most of the recent losses experienced on private ILS instruments are linked to non-natural catastrophes, such as the wreckage of the Costa Concordia, the Tianjin harbor chemical blast, or also the Jubilee oil field business interruption loss. The Jubilee FPSO event is an illustration of the expansion of the ILS market towards new lines of business, including marine and energy. It is also a good example of a complex man-made loss event: a failure of the turret of the floating oil production vessel in March 2016 led to multiple production shutdowns, increased production costs and long lasting repairs, which are still in progress and which triggered significant insurance claims.

Diversification and risk mutualisation: a multiple dimension approach



Source: SCOR Investment Partners ©. For illustrative purposes only

What are the options to enhance the diversification of a natural catastrophe (nat cat) portfolio?

An ILS portfolio with a significant focus on nat cat does not mean a less diversified portfolio. In fact, diversification can be achieved through the multiple dimension of the risks involved in an ILS contract.

In addition, to the obvious segmentation by peril/ region or peril/sub region, portfolio managers can enhance the diversification of the funds they propose by diversifying their exposure per type of trigger, type of event sequencing and by level of attachment. As a result, using these different layers of diversification allows a portfolio manager to hold various securities covering the same event while reducing its risk.

Two ILS instruments exposed to the same event won't necessarily behave the same way. For example, consider a portfolio manager exposed to a second event hurricane in Florida at a lower attachment point and to a first event hurricane in Florida at a much higher attachment point. With the occurrence of a severe hurricane in Florida, the first exposure won't be triggered, because it is the first event of the season, and the second exposure won't be affected either because the attachment point is not reached.

Currently, the attachment point dimension is quite interesting for peak perils, showing the best risk-adjusted return levels of the market. The exposure to this type of perils through instruments with higher attachment points is a good way to combine yield and risk control.

When using the different levels of diversification at its disposal, a portfolio manager can achieve satisfying risk control while benefiting from the attractive yield of peril risks.

The range of ILS investment strategies proposed to pension funds is extremely wide. Before getting involved an investor should ask itself what level of liquidity he needs (weekly, monthly, annual?), what level of return is targeted and what level of risk/drawdown can be accepted.

As an illustration, we propose a blended strategy combining 2/3 of cat bonds and 1/3 of OTC that offers enhanced diversification with a monthly liquidity. This type of strategy has encountered significant success among investors looking for recurring yields and decorrelation.

Nevertheless it is important to highlight and repeat that the asset class involves significant insurance risks in case of the occurence of one or a succession of severe natural disasters. ■

In association with

SCOR Investment Partners

INVESTMENT

An attractive niche

Sandra Haurant examines the case for investing in insurance-linked securities

WRITTEN BY SANDRA HAURANT, A FREELANCE JOURNALIST

Insurance-linked securities, or ILS, are essentially debt instruments that are generally used by insurance and reinsurance companies to transfer the risk of loss to the capital markets. There are a number of different types of ILS, but perhaps the most familiar is the catastrophe, or cat bond, which, as the name suggests, is used by the issuer to cover the risk of a catastrophe, for example an earthquake or a hurricane.

These securities pay a coupon to the investor during their lifespan, as long as none of the catastrophes they cover occurs. If an event covered by the bond does happen, and the issuer suffers losses, then the investor is likely to lose coupons and principal, depending on agreements in place.

ILS as an asset class fits firmly into the alternative sphere, and this was once considered an extremely niche area of investment. Indeed, its reach remains relatively small-scale in terms of assets under management. According to the Willis Towers Watson Global Alternatives Survey 2017, pension fund assets managed by the top 100 alternative asset managers in the sector amounted to $1,611 billion in 2016, of which around $9.4 billion was allocated to ILS, making it the smallest asset class, coming in just after natural resources. Of the other alternatives, real estate was most popular, followed by private equity funds of funds, direct hedge funds, infrastructure funds, illiquid credit, direct private equity funds and funds of hedge funds.

Growing interest

It may be starting from a small base, but interest is growing, with some sources claiming that the number of pension funds with an allocation to ILS and other reinsurance linked assets has doubled from 1 per cent to 2 per cent. In some countries, ILS has been attracting attention for some time. The Netherlands and Nordic countries, often frontrunners with burgeoning areas of investment, have been enthusiastic, but perhaps the earliest adopter in this area was Switzerland.

"Pension funds in Switzerland have known about and been invested in ILS for a very long time, some since the middle of the 2000s," explains Scor Investment Partners head of ILS Vincent Prabis. "One of the reasons is proximity. Some of the first funds dedicated to ILS were launched in Zurich. Most of the insurance and reinsurance industry is based around Zurich, and because of long historical ties between pension funds and the insurance and reinsurance industry, there was a pretty quick take-up rate and a clear understanding of what ILS was setting out to do."

It's not just a question of geography though; another key driver in Switzerland is arguably a long run of low interest rates, currently standing in the negatives at -0.75%. Willis Towers Watson head of advisory portfolio management Alasdair MacDonald says: "The search for yield began more recently in the UK and Europe, but in Switzerland it has been ongoing for a long time and very limited government bond issuance, and insurance-linked securities do look like a slightly higher yielding bond."

Low yields elsewhere are certainly a driver for this area of investment, agrees Prabis. "The number one is definitely the low-yield environment. Interest rates have been low for quite a while, and while there seems to be a form of consensus that sooner or later they will rise, it will be later than was anticipated a few years ago and, slower than was anticipated even recently," he says.

"That low yield environment forces pension funds to look at places where they didn't look before. They are reviewing and allocating to other asset classes, particularly on the alternative side, which seems to be the only place where they are able to find some value and some much needed yield."

Lack of correlation

Another draw is ILS's lack of correlation with other asset classes, which makes a very strong case for ILS as a diversification element in a portfolio, adds Scor Investment Partners ILS portfolio manager Sidney Rostan. "It is very attractive because of decorrelation and diversification," says Rostan. "This asset class has proven to be decorrelated from almost all the asset classes, including the mainstream ones, but also other alternative asset classes, through the crisis and also more recently at the beginning of 2016, these assets hadn't been affected at all by overall market turmoil."

Solvency II, the EU-wide harmonised regulatory regime essentially designed to make certain insurance companies have the required capital to meet their obligations, has also helped raised the profile of the ILS. "One question that is raised by potential investors, who understand very well what we are doing, is: 'Why do you have access to this risk? Why don't insurance and reinsurance companies that worked together for hundreds of years keep it to themselves?'" says Prabis. "There are a number of reasons why reinsurance and traditional insurance companies need ILS now to cover their own needs, but one of them is Solvency II."

Managing risk

Of course, ILS, including cat bonds, are not invulnerable. By their very nature, they can literally be shaken to their core in the event of an earthquake, or, as we have seen recently, blown off course by a hurricane. Hurricane Harvey left a trail of destruction across Texas and Louisiana, bringing with it tragic loss of life and environmental devastation.

The economic impact of the disaster will take time to calculate, and at the time of writing estimates covered an enormous range, and reached as high as $190 billion. In 2005, Hurricane Katrina cost around $160 billion. Just how these losses will affect the insurance, reinsurance and ILS markets is not yet clear, explains AXA Investment Managers head of ILS Francois Divet.

"Economic losses are not [likely to be] so relevant for insurers and reinsurers and ILS managers, because in the ILS space, as with traditional insurance and reinsurance, we only cover the losses that are covered through an insurance policy," he says.

When it comes to insurance for these kinds of events, wind damage is usually the key element that is covered, and, says Divet: "Most of the costs [here] are not coming from the wind when the hurricane made landfall, they are mainly coming from flooding, and in the insurance market the flood policy is not mandatory, meaning that you have a limited number of personal individuals purchasing this insurance policy for flooding."

Losses with ILS are generally triggered by the losses reaching a certain threshold – and even if the losses caused by Harvey do not reach that level, subsequent hurricanes might reach the limit on an aggregate basis. "Because of these mechanisms, even if the cat bonds are not triggered by an event such as Harvey, they may suffer mark to market decrease because the probability of the trigger in the next event is higher," says Divet.

Meanwhile, losses caused by events such as these may lead to a rise in premiums, and this, says MacDonald, often leads to an increased interest in the ILS market. Recently, he says: "Premium rates have fallen to low levels, so it has reached a point where you are not getting very well compensated for the risks you are taking. Harvey may change that significantly, although we can't yet say what the impact has been."

ILS remain a niche asset class, and although they are becoming better known, there is still a long way to go before they are anywhere near mainstream. "Understanding ILS is definitely a hurdle," says MacDonald, but then, he argues, there are also other areas competing to provide an answer to the yield question – citing property and less liquid credit markets as potentially more attractive options.

The future for ILS, then, is unclear. But one thing is for certain, its ability to buck market trends will continue to make this asset class something of a one-of-a-kind in the investment world, says MacDonald: "The one thing you can't take away from ILS is that it is the only genuine guaranteed-to-diversify asset class on the planet, because hurricanes don't cause equity crashes, and equity crashes don't cause hurricanes or earthquakes." ■

In association with

SCOR Investment Partners